Service Date: June 8, 1987

DEPARTMENT OF PUBLIC SERVICE REGULATION
BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MONTANA

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IN THE MATTER Of The MONTANA PUBLIC SERVICE COMMISSION's Investigation of FEDERAL TAX REFORM Impacts on Public Utility Revenue Requirements.	UTILITY DIVISION DOCKET NO. 86.11.62 ORDER NO. 5236c

Introduction

On November 24, 1986, the Montana Public Service Commission (MPSC or Commission) initiated this Docket with an Order to Show Cause that existing rates for public utilities remain just and reasonable following the Tax Reform Act of 1986 (TRA). All respondents were ordered to provide the information required by the Commission's minimum filing requirements on or before February 1, 1987. Following those filings, it became immediately apparent that a consistent interpretation of the TRA is necessary in order to evaluate that information.

On March 4, 1987, the Commission issued a Preliminary Procedural Order in this Docket. Order No. 5236a asked parties to file briefs which addressed 12 issues and invited parties to comment on any other issues. The first round of briefs were to be filed by March 27, 1987 with answer briefs due on April 10, 1987. A number of companies and Montana Consumer Counsel (MCC) asked for an extension of time to file their briefs. At its March 16, 1987 agenda meeting, the Commission approved an extension of time to file opening and answer briefs. The new dates were: First briefs due by April 7, 1987, and answer briefs due by April 21,1987.

Initial Briefs were received from Montana Consumer Counsel (MCC), Butte/Anaconda Water Company (B/AW), Montana-Dakota Utilities Company (MDU) (electric and gas), Montana Power Company (MPC) (electric and gas), AT&T, General Telephone Company of the Northwest (GTE), Great Falls Gas Company (GFG), Mountain Bell(MB), Mountain Water (MW), and Northwestern Telephone Systems (NWTS). Montana Light & Power Company (ML&P) declined to make any comments in this Docket noting that no taxes are included in the Company's rates. Pacific Power & Light Company (PP&L) did not file comments in the first round, but did file an Answer Brief. Answer briefs were also received from MCC, AT&T, MDU (electric and gas), MPC (electric & gas), MB, and PP&L.

This order will be organized in the same topical manner as the questions set forth in the Preliminary Procedural Order. Although tariff changes will not be ordered here, the Commission intends that direction given here may be applied to utilities results of operations filed in Docket No. 86.11.62. Such application may result in tariff changes being ordered on an interim basis and/or a final basis.

Discussion and Analysis

1. Tax Rate

Section 601 of the TRA lowers the marginal tax rate for corporate taxpayers from 46 percent to 34 percent effective July 1, 1987. A blended rate is required for taxpayers whose fiscal years end later than June 30. A calendar year taxpayer, for example, would be subject to a blended rate of 40 percent[1].

The Commission requested comments regarding whether, for ratemaking purposes, a 34 percent tax rate may be applied beginning July 1, 1987, if no change has been recognized for the first half of 1987. For the reasons set forth below, we conclude that recognizing the 34 percent rate on July 1 is the fairest and most consistent ratemaking approach.

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[1] AT&T and MDU point out that the precise rate would be 39.95 percent (181 days at 46 percent and 184 days at 34%).

It is commonly recognized that ratemaking is essentially a forward-looking exercise. The Commission sets rates that will be just and reasonable during the period when they will be in effect. The Commission believes that any change in rates resulting from this TRA investigation will primarily be in effect while the marginal tax rate is 34 percent. Absent extraordinary circumstances, it would not be proper to set utility rates on the basis of a transitional tax rate.

The utility companies have generally raised two concerns in response to the Commission's query. They first suggest that the timing of revenues and expenses could cause some tax collection mismatches if different rates are applied during the year. The Commission agrees with that analysis, but is not persuaded that applying the 34% rate is therefor unjustified or unfair. Any mismatch is speculative and could go either way; i.e., to the benefit of the companies or to their ratepayers. More significant, however, is that the alternative (46% for half of the year and 40% for the remainder) would result in a much more certain and larger mismatch. Neither approach is perfect, but recognizing the 34% rates after July 1 is by far the most reasonable.

The companies also contend that applying a 34% rate after July 1, 1987, would violate normalization provisions requiring that income tax expense and reserves for deferred taxes be calculated at the statutory rate. AT&T's initial brief describes this position in some detail. The Commission is persuaded by MCC's analysis of this issue. The correct rate for 1987 is 39.95% and this rate should be used to calculate deferred taxes. It defies logic, however, to contend that an annual rate of 39.95% will be achieved by applying 46% for half of the year, and 39.95% for the other half. The

calendar year companies should book deferred taxes at a 39.95% rate for the entire year. Revenues collected through the ratemaking process are most likely to match deferred tax expense if a 34% tax rate is applied after July 1, 1987.

The Commission believes that the utilities will not be unfairly treated by using a 34% rate. Rates collected during the first half of 1987 have included a 46% tax rate. Failure to reflect a 34% rate for the remainder of the year would surely result in collections exceeding 1987 tax liabilities. Recognizing the permanent tax rate change after July 1 is the approach most likely to result in matching tax collections with tax liabilities.

It must be noted that a tax rate change has already been incorporated in MDU's (Sub No. 6) and PP&L's (Sub No. 14) electric rates. In those particular cases, it would not be reasonable to review rates on the basis of a 34 percent tax rate for the second half of 1987. This would result in an assured mismatch of tax liabilities and revenues, and it would be virtually certain that tax collections would fall short of funding deferred tax liabilities. The Commission concludes that such an unfair result outweighs the need to set longer-range prospective rates. A procedure should ultimately be established whereby MDU's and PP&L's rates can be changed to reflect the 34 percent tax rate and all other aspects of this order on January 1, 1988.

2. Unbilled Revenues

The Tax Reform Act of 1986 calls for revenues associated with service which has been rendered at year's end, but for which bills have not been sent, to be gradually included in taxable income

in the year service was rendered. A four year phase-in period is allowed. Unbilled revenues are most significant for the energy utilities.

The preliminary procedural order requested that parties address the ratemaking propriety of reflecting increased tax expense from unbilled revenues. AT&T, GTE, MB, and NWTS stated they were not affected due to their use of accrual accounting. B/AW, MW, GFG, MPC and MCC believe that, although actual tax expense may increase, ratemaking adjustments are unnecessary since test year revenues and expenses had formerly been properly matched. MCC further reasoned that reflecting increased tax expense for ratemaking would require an offsetting adjustment to recognize those revenues for ratemaking. MDU viewed the new taxation of unbilled revenues as a prepaid tax requiring a working capital adjustment.

On the issue of reflecting for ratemaking the taxation of unbilled revenues, the Commission finds the reasoning of the majority of the respondents to be persuasive. Revenues and expenses have previously been properly matched. The matching has been of a hypothetical, best estimate nature, in order that ratemaking accurately reflect costs for the future period in which rates would be effective. To deviate from this practice simply because tax reform has been enacted would be unprincipled and inconsistent. Accordingly, the Commission believes that tax expense on unbilled revenues should not be reflected for ratemaking.

One final matter is MDU's request that the inclusion of unbilled revenues in actual taxable income be reflected as a working capital item. MCC's Reply Brief (p.5) addressed this issue:

> "Montana ratepayers have not received any benefit of a decreased working capital re-

> quirement in the past because of the post-ponement of the payment of taxes on unbilled revenues and should not now be required to pay a return on booked deferred income taxes as related to this revenue."

The Commission finds the MCC's reasoning to be persuasive, and therefore rejects MDU's position.

3. Excess Deferred Taxes

Differences in the period a revenue or expense item is recognized for tax purposes and the period it is recognized for book purposes result in book/tax timing differences. Utilities record deferred taxes on these timing differences. The deferred taxes represent a liability to the federal government for future taxes. For ratemaking purposes, these timing differences have been treated under either "normalization" or "flow-through". Normalization means that ratepayers pay rates that reflect taxes based on book revenues and expenses. In other words, the ratepayers pay the utility for taxes that the utility will not actually pay to the federal government until some future period. Ratepayers then do not pay for these taxes in future periods when the timing difference "reverses" and the utility actually pays the taxes to the federal government. Flow-through refers to the situations in which the ratepayers pay rates that reflect the utilities' current tax liability. Ratepayers experience current savings by only paying for the taxes that the utility actually pays on a current basis. In the past, many utilities have experienced growing deferred tax balances. These utilities have a net savings each year from tax timing differences. In the past, the Commission has often required utilities to set rates based on the flow-through method to insure that ratepayers actually receive benefits from current tax savings to the utility. However, the IRS has not allowed flow-through in some situations. Utilities must normalize the timing differences caused by accelerated depreciation expenses available for tax purposes. Therefore, current ratemaking reflects a combination of normalization and flow-through for various types of timing differences.

Utilities have been deferring taxes related to timing differences at the marginal tax rate of 46%. The TRA decreases this

rate from 46% to 34%. This causes a situation where ratepayers have provided for future taxes at a 46% rate and those taxes will actually be paid at a 34% tax rate. This results in an amount in the deferred tax balance that represents taxes paid by ratepayers that will never have to be paid to the federal government. It is helpful to think of the deferred tax balance in two parts: the amount that represents a payable to the federal government, and an amount that represents a payable to ratepayers. This latter portion is referred to as "excess deferred taxes".

All parties to this proceeding agree that the TRA requires the utility to pay back excess deferred taxes that are depreciation-related using the average rate assumption method. This method is defined in Section 203 (e)(2)(b) as:

> ". . . the method under which the excess in the reserve for deferred taxes is reduced over the remaining lives of the property as used in its regulated books of account which gave rise to the reserve for deferred taxes."

If the Commission does not use this method in setting rates, the affected utilities could loose the ability to use accelerated depreciation rates for tax purposes. Taking an action that would deny the utility the use of accelerated depreciation rates for tax purposes would harm the utility financially and could cause higher rates to ratepayers. Therefore, the Commission finds that all Montana utilities must use the average rate assumption method to flow back the excess deferred taxes to ratepayers.

Although the TRA specifies that the average rate assumption method must be used to amortize the excess deferred taxes that are depreciation related, it does not specify whether the calculations

for the amortization must be by vintage of plant and by plant account or by some weighted average of all accounts and lives. Mountain Bell is grouping the assets by vintage by account. This results in a faster amortization than if all assets were grouped in aggregate to calculate the average life and rate.

The average rate assumption method results in a very gradual pay back of excess deferred taxes to ratepayers. In fact, some utilities noted that the first year amortization was insignificant and did not adjust their data for it. The Commission finds that the most rapid pay back possible in keeping with the TRA requirements must be used by utilities. Therefore, utilities should group assets in the most advantageous way for accelerating the amortization.

The TRA does not address the amortization of deferred taxes that are not depreciation-related. All parties addressing this issue agreed that, if ratepayers provided for the deferred taxes, then ratepayers should receive the benefit of the amortization of the excess deferred taxes. Parties did not agree on the timing of the amortization. MCC's position is that these excess deferred taxes should be subject to immediate flow-through. MPC proposes to amortize the excess deferred tax balance attributable to the Bear Paw properties over two years and the balance attributable to the noncash revenues from the Rate Moderation Plan over five years. MBT, GFG, and MDU favor full normalization (the average rate assumption method) for these excess deferred taxes. PP&L's position is that these excess deferred taxes should be looked at individually, and no decisions should be made on a generic basis.

The Commission agrees that, to the extent that ratepayers have provided deferred taxes that no longer represent a payable to

the federal government, those ratepayers should be repaid. Although the balances have been accumulated over a number of years, this in itself is not a persuasive reason to delay repayment to ratepayers. Ideally, the same ratepayers that paid these taxes would now be repaid. That exact matching is not possible. However, the longer repayment is delayed the less likely that the same ratepayers that paid the taxes will be repaid. The Commis sion concludes that to the extent ratepayers paid excess deferred taxes in the past they should be repaid over a period of two years. Because these deferred taxes are not expected to be large amounts, a two year amortization should not be financially burdensome to any utility.

MPC's proposal to amortize excess deferred taxes related to the noncash revenues on the Rate Modification Plan presents a different case. Ratepayers have not actually paid for these taxes and a five year amortization would match the remaining time of the Rate Modification Plan. The Commission believes that this approach is reasonable.

4. Expense To Capital Shift

The TRA provides that many items previously expensed on tax returns will be capitalized and recovered through tax depreciation. For financial accounting and ratemaking this will, in many instances, create timing differences. Previously, many of these items were expensed for both IRS and financial accounting/ratemaking.

Several items listed by the parties were previously expensed for tax purposes but will, because of the TRA, be capitalized: certain indirect costs such as administrative support, current pension expense, officers' salaries, certain insurance, taxes and

certain depreciation. Also listed were property taxes, sales and use taxes, certain employee benefits and interest expense on self constructed property. Consistent with the procedural order (question 4c), interest expense is addressed separately following discussion of proper ratemaking treatment for all other question #4 items to be capitalized according to the TRA.

Before the TRA, several utilities capitalized various of the above items for financial reporting/ratemaking but deducted them as expenses on their tax returns. The utilities will now capitalize these items for tax purposes thereby creating a matching. Accordingly, the Commission need not further consider here ratemaking treatment for them. Several utilities, however, expensed certain of these items for both financial reporting/ratemaking and tax statements.

The MCC framed the ratemaking issue:

> "But what of the utility that was previously expensing these items for book and tax purposes? The MPSC allowed these utilities to include the expense and the tax effect in the ratemaking formula. Now, these utilities apparently desire to continue their capitalization policies for book purposes. That is, the expense would still be included in the revenue requirement, but under the guise of "flow-through", they would deny the ratepayers a tax deduction currently. Although the MCC does not believe that the tax law should dictate ratemaking policy, we believe the result of what these utilities are attempting to do is unfair and creates an unnecessary book/tax timing difference." (MCC Reply Brief pp 6, 7)

The MCC further argued that fairness demands tax reporting and financial reporting/ratemaking capitalization policies remain consistent so that ratepayers not be unfairly penalized.

Several of the utilities, as typified by MPC's comments, framed the issue somewhat differently:

> "The Company has applied the flow-through methodology to these items because we believe that to be the most accurate application of Commission precedent. It would be appropriate to provide deferred income taxes for these costs in an unregulated environment or in a jurisdiction which requires comprehensive interperiod tax accounting (e.g. FERC). To provide deferred tax accounting to these items would reduce revenue requirements. The Company could support deferred tax accounting only if it were applied equally to items which lower income tax expense." (MPC Initial Brief, p 8)

The Commission agrees with MCC's reasoning: similar capitalization practices have previously allowed items to be fairly expensed both for tax and book purposes. A change in the tax law should not dictate a costly change in that relationship. The Commission believes, however, that utilities should have an opportunity to specifically address each item for which capitalization policies could be changed (see PP&L's Brief, p 4, line 21-p 5, line 10). Accordingly, until these are addressed, a middle ground between completely capitalizing and completely expensing those costs affected by the TRA is proper. The mechanical process to achieve a balanced result will be to provide deferred taxes for these timing differences. By using deferred taxes, a reasonable balance will result, although the utilities will still receive more than 50% of

the increased revenue requirement currently. The balance will become part of the utilities' rate base and will earn a rate of return.

Several utilities argued that deferred taxes should not be provided because Commission precedent has dictated they not be used (see #28). Those parties failed to mention, however, that the Commission has ordered the use of deferred taxes for the lion's share of dollars arising from timing differences--those asso ciated with using accelerated tax depreciation[2]. The respondents

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[2] If the Commission did not allow deferred taxes for accelerated tax depreciation (ATD) the utilities would not be able to use ATD on their tax returns, thereby robbing utility investors of the free use of other taxpayer's dollars. This benefit allows the utilities to forego obtaining these monies from the capital markets; a benefit which also inures to ratepayers. Ratepayers, however, pay for this benefit because deferred tax expenses must be provided on the accelerated tax depreciation timing difference.

are correct, however, when they assert that, absent extenuating circumstances, the Commission's policy has been to not provide deferred taxes for timing differences. Both for accelerated tax depreciation and these timing differences occasioned by the TRA, however, the Commission finds that valid reasons exist, as previously discussed, to provide deferred taxes.

As noted above, question 4c asked respondents to discuss changes in the treatment of Allowance for Funds Used During Construction (AFUDC). AT&T stated that the TRA requires capitalized interest where interest expense could have been avoided if construction were avoided. The provisions apply to: real property, property with a class life of 20 years or longer and property which takes more than two years to produce or takes one year to produce and costs $1 million or more.

MDU properly commented that the TRA "methodology assumes that debt is used to finance the entire cost of the construction project. The cost of debt specifically identified with the asset is first capitalized. The average embedded cost of debt is used to capitalize interest on the excess of total asset cost over specifically identified debt. Thus the interest capitalized for tax purposes will not equal the AFUDC capitalized for book purposes." (MDU brief, response to question 4c). MCC, in its initial brief (pp.8, 9), suggested that deferred taxes associated with the difference be used for ratemaking. Other respondents, such as MPC disagreed (see MPC Reply Brief, p.3).

The Commission concludes that the provision of deferred taxes for this timing difference would be improper. Because of the way AFUDC is treated for ratemaking, the Commission could not reasonably use the TRA method of capitalizing interest for ratemak-

ing. To do so may result in an equity rich capital structure associated with plant-in-service and excessive debt allocated to construction. Since the prospect of equalizing the capitalization practices for financial reporting/ratemaking and tax purpose is not reasonable here, as it may be for items referred to in #25, it is appropriate to flow through the difference. In this instance, ratepayers will be charged higher rates to allow for this treatment.

5. Inventory Costs

The TRA requires that certain costs associated with inventory be capitalized rather than deducted as tax expenses. The TRA requires the capitalization of costs related to the production of inventory under rules similar to the tax accounting rules for extended period long-term contracts.

AT&T specified seven categories of expenses which will now be required to be capitalized (page 4, Opening Brief). The rules apply to inventory produced by the taxpayer, inventory purchased by the taxpayer for resale, and self constructed property. B/AW and MW commented that only taxpayers with average gross receipts in excess of $10,000,000 (for the past three years - computed annually) are affected by the new provisions. Both companies stated they were not affected. GTE stated that this section applies primarily to manufacturers. GFG stated that since they do not store gas but buy it at the city gate, the only cost which should be capitalized would be the salary of the gas purchaser allocated to the total gas purchased over the year divided by the ending inventory of gas. The company does not maintain inventory for resale. MDU noted that

storage costs would be included as an indirect cost. In the case of natural gas inventories acquired for resale, indirect and interest costs will be required to be capitalized for tax purposes. Thus, the tax basis of the inventories will generally exceed the book basis, which may give rise to prepaid income taxes. MPC stated that costs previously expensed for book and tax purposes must now be included in inventory for tax purposes to the extent these costs relate to operating and maintaining storage gas inventories. MB stated it does not produce or purchase inventory for resale. NWTS responded that the regulated portion of its business does not hold inventory for resale. MCC referred to its answers to question #4.

Part B of this issue queried the parties about the appropriate ratemaking treatment for this change in the tax law. AT&T argued that deferred taxes should be used for book/tax differences. B/AW and MW did not comment. GTE indicated that ratemaking will not be affected. GFG stated that deferred tax accounting should be considered to handle book/tax differences. MDU agreed with GFG. MPC stated that the additional tax expense should be included in the cost-of-service, with no provision for deferred income taxes. NWTS did not respond, while MCC referred to its answer to question #4.

The Commission believes that the ratemaking aspects of this issue are similar to items referred to in #25. MCC is also of this opinion, and accordingly adopted its responses to question #4 as appropriate for this question. Inventory costs were formerly expensed for both financial reporting/ratemaking and tax purposes. The TRA causes these amounts now to be capitalized for tax purposes.

Because this issue is very similar to that discussed under question #4 , the Commission finds it appropriate to adopt its

reasoning in #'s 29 and 30. Accordingly, until the issue of capitalizing inventory costs for book purposes is addressed, the Commission finds the provision for deferred taxes to be appropriate for ratemaking.

6. Contributions In Aid Of Construction (CIAC)

The TRA provides that contributions in aid of construction (CIAC) must be included in a utility's calculation of gross income. Order No. 5236a posed three questions regarding this change in tax treatment of CIAC:

> 1) Are there allowable alternatives to inclusion of CIAC in gross income?
>
> 2) Who should be responsible for the tax effect of including CIAC in gross income?
>
> 3) Please comment on the appropriateness of the Commission estimating the present value of future tax savings in its calculation of the tax impact of including CIAC (in gross income)?

MCC and those companies affected by the change in the treatment of CIAC indicated that there is no allowable alternative to the inclusion of CIAC in gross taxable income. Since there is no allowable alternative to including CIAC in gross income, the Commission must address the question of who should be responsible for the payment of taxes associated with CIAC.

The companies are evenly divided over who should be responsible for the additional tax expense associated with CIAC. Half of the companies indicated that the person or entity making the contribution should be responsible, while the other half argue that

the general body of ratepayers should be responsible. Those companies supporting the position that ratepayers should be responsible for the additional tax expense, in general, responded that making the cost causer responsible for payment of the additional tax would have a negative effect on future development.

Generally, those companies supporting assessment of the tax expense against the cost causer did not provide a specific rationale for their position. The indications were that the cost could be directly identified with the CIAC and, therefore, should be assessed against the person or entity making the contribution.

The MCC did not support any particular position regarding responsibility for payment of taxes associated with CIAC. Instead, the MCC provided the Commission with three alternatives that it felt could reasonably be used by the Commission for treatment of CIAC: 1) include CIAC in gross revenue for both ratemaking and tax purposes, 2) require the cost causer to also provide revenues sufficient to pay the income tax, or 3) require the amount of the CIAC collected from the individual to be calculated as the amount of the CIAC before the tax change plus income taxes related to the CIAC under the TRA less the present value of the utility's estimated future tax savings due to tax depreciation of the asset. Under this approach, CIAC would not be included in taxable income for ratemaking purposes.

While MPC supported assessing the additional tax associated with CIAC against the ratepayer, it stated: "MPC has not yet concluded what the proper treatment should be, and it believes that this issue deserves more careful consideration than will be devoted to it in the context of this proceeding." The Commission agrees with MPC's statement that this issue deserves careful consideration before a final decision is made regarding proper treatment of this tax

expense. It is incumbent upon the Commission, however, to provide the utilities with direction regarding responsibility for payment of the tax expense.

The Commission is of the opinion, given the fact that the specific cost causer can be identified, that the person or entity making the contribution should be responsible for payment of the additional tax expense. The Commission finds MCC's third alternative preferable, therefore, because it recognizes that the cost causer is responsible for the additional tax, but it also recognizes that this expense should be reduced by the amount of the present value of the future tax benefits. Although the MCC reasoned that its application could be administratively cumbersome, the philosophy of granting future tax benefits to those paying associated current tax expense is overriding for CIAC.

Utilities affected by the change in tax treatment afforded CIAC, will be required to file with the Commission, by August 1, 1987, the proposed calculation to be used in determining the amount of tax to be collected.

7. Changes In The Accelerated Cost Recovery System

The TRA revised the depreciation rates used by utilities to calculate depreciation for tax purposes. In general, the TRA property lives will be longer than previous tax lives. This may adversely impact the cash flow of utilities by increasing current tax liability. The TRA continues the requirements of normalizing depreciation related book/tax timing differences. The Commission believes that no contested issues exist in this area.

8. Entertainment Expense

Section 142 of the TRA sets limitations on deductions for meals, travel and entertainment expense. All parties commenting on this section of the TRA agreed that the additional tax expense associated with the limitation is includable for ratemaking purposes as long as the expense is properly includable in the revenue requirement. The Commission concurs with the parties' analysis of this section and concludes that expenses that are properly includable in the revenue requirement are subject to an allowance for additional tax expense.

9. Investment Tax Credits

Section 211 of the TRA eliminated Investment Tax Credits (ITC's) for most property placed in service after December 31, 1985. Exceptions to this rule exist for transition property, which is property with binding construction contracts in place as of a December 31, 1985 cut off date. The TRA requires deadlines for transition property to be placed in service as follows:

July 1, 1986, for property with an ADR midpoint life of less than five years.

January 1, 1987, for property with an ADR midpoint life of at least five years but less than seven years.

January 1, 1989, for property with an ADR midpoint life of at least seven years but less than 20 years.

January 1, 1991, for property with an ADR midpoint life of 20 years or more.

Order No. 5236a requested that parties discuss: 1) the effect ITC elimination would have on ratemaking and, 2) the required regulatory treatment for restoral of ITC's previously taken. The parties stated that ratepayers and stockholders would both be negatively impacted by ITC elimination. However, the immediate ratemaking impact of the repeal is not expected to be significant. All parties agreed that no changes should be made to the present methods of ITC restoral. ITC's are required to be restored over the lives of the associated assets. The Commission concludes that the elimination of ITC's requires no change in regulatory treatment of this issue.

10. Research Tax Credits

The TRA reinstated research tax credits for qualified research expenditures in excess of such expenditures incurred during the base period. The base period is defined as the three prior taxable years. Qualifying research expenditures are generally technological in nature and intended to aid in the development of new or improved products. Research payments made to others will qualify for research tax credits subject to limitations described in IRC Section 231.

Comments received on this issue were in agreement that the TRA does not require a specific ratemaking treatment of this credit. MCC stated that the TRA does not prohibit flow through of the credit, and that ratepayers should immediately be allowed the benefit of the decreased tax expense. MBT argued that the Commission has previously disallowed various research costs, and that ". . . to the extent that research costs are not allowed in ratemaking as operating expenses, any associated tax credit should not 'inure to the benefit of the ratepayers'."

The Commission agrees with MCC that the decreased tax expense should be flowed through immediately. The Commission also agrees with MBT that if certain research expenditures were not previously reflected in rates, then the associated tax credits also should not be reflected. Therefore, to the extent ratepayers have been paying research expenditures, the associated research tax credits must be immediately flowed through and reflected in rates.

11. Reserve For Bad Debts

Section 805 of the TRA disallows the use of a reserve for bad debts. Accordingly, utilities that currently use the reserve method will have to convert to a direct write-off method for bad debts. Section 805 of the act also requires that the bad debt reserve "be taken into account ratably in each of the first 4 taxable years beginning after December 31, 1986." All utilities previously using the reserve method for bad debts will have additional taxable income over the amortization period.

The MCC recommends that the Commission, for ratemaking purposes, recognize that the reserve for bad debts is non-investor supplied. To accomplish this, MCC proposes that the Commission reduce the rate base by the average unamortized balance of the account over the four year period and provide for amortization (net of taxes) to income ratably over the four years.

The Commission finds that the proposal of the MCC is reasonable. Those utilities amortizing the reserve for bad debt should use the MCC proposal for ratemaking purposes.

CONCLUSIONS OF LAW

1. The Commission has authority to supervise, regulate and control public utilities. Section 69-3-102, MCA.

2. Respondents are public utilities subject to the Commission's jurisdiction. Section 69-3-101, MCA.

3. The Commission may regulate the mode and manner of all investigations and hearing of public utilities. Section 69-3-103, MCA.

4. This Order establishes consistent standards appropriate for this Docket. Utility rates, tolls and charges must include the effects of the Tax Reform Act of 1986, as described in the foregoing sections of this Order, to be just and reasonable. Revenues collected on the basis of conflicting tax interpretations would be unjust and unreasonable. Section 69-3-330, MCA.

ORDER

1. The interpretations of the Tax Reform Act of 1986 set forth in preceding sections of this Order are deemed to be generally established principles of utility rate regulation, and the existing methodology to be applied in determining utility tax liabilities.

2. The Commission will evaluate the responsive filings in this Docket in view of the tax change effects described herein.

3. Interim rate orders may be issued in individual sub-dockets where Commission review of the utilities' responsive filings determines that existing rates may be excessive. Preliminary prehearing conferences will then be scheduled to establish hearing procedure.

4. Where the Commission concludes that existing rates of a particular utility do not appear from its filing to be excessive, an opportunity for comment will be provided regarding the Commission's intent to close that sub-docket.

5. Utilities affected by the change in tax treatment for contributions in aid of construction shall file with the Commission, by August 1, 1987, proposals for determining the amount of tax to be collected pursuant to paragraph 45 of this Order.

DONE AND DATED this 5th day of June, 1987, by a 4 - 0 vote.

BY ORDER OF THE MONTANA PUBLIC SERVICE COMMISSION

_____
CLYDE JARVIS, Chairman

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JOHN B. DRISCOLL, Commissioner

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DANNY OBERG, Commissioner

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HOWARD L. ELLIS, Commissioner

ATTEST:

Ann Purcell
Acting Secretary

(SEAL)